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PACIFIC TELESIS
Group-Washington

March 17, 1997

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-262 - Access Charge Reform*
CC Docket No. 96-45 - Universal Service

On Friday, March 14, 1997, Rex Mitchell and Nancy Lubamersky of Pacific Bell and Nancy Woolf and I of Pacific Telesis met to discuss the attached material with:

- Jim Coltharp (Legal Advisor to the Commissioner Quello)
- Kathleen Levitz (Deputy Bureau Chief of the Common Carrier Bureau), Tim Peterson (Common Carrier Bureau and Katherine Schroder (Competitive Pricing Division)

In addition, copies of the written material were delivered to Jim Casserly (Senior Legal Advisor to Commissioner Ness) and John Garcia (Policy and Program Planning Division).

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's rules. Because the meetings extended until late in the afternoon, this notice is being filed on the next business day.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions.

Sincerely,

Jay Bennett

Attachment

cc (w/o attachment): J. Coltharp, K. Levitz, T. Peterson, K. Schroder, J. Casserly, J. Garcia

Access Reform and Universal Service Solutions

Nancy Lubamersky
Rex Mitchell
Nancy Woolf

Any Integrated Solution Must Ensure *Full* Recovery of Costs Allocated to the Interstate Jurisdiction

- LEC access prices are based on the costs allocated to the interstate jurisdiction by the separations process and must be recovered
- If interstate access prices are reduced, then some alternative means of cost recovery must take its place
  - One method, which we favor, is to increase the single-line SLC in combination with an appropriately sized Universal Service Fund
- Until separations reform, the determination of full and proper cost recovery must be made in the access reform proceeding

Overall "Compromise" Solution Proposal

- A "compromise" solution should maximize benefits for consumers and competition
  - ➔ Lower access charges
  - ➔ Preserve universal service and affordable residential basic rates in all geographic areas
  - ➔ Encourage competition and investment in all areas, rather than just in low cost/high revenue areas

"Compromise" Solution Details

Solution Elements	Description	Benefits	PB Impact
• Significant Access Price Reductions	• Switched access prices are "pegged" to an industry average of $0.01 per minute • No company's access charges should be forced below $0.01 until geographic deaveraging of all elements is implemented	• *Should* lower long distance prices for consumers • Stimulates competition and investment	• $0.01 per minute • $295M revenue reduction
• Per-Line Charge <u>Preferred Option:</u> *Modest Per-Line Charge (SLC) Increase*	• SLC on single line end-users increased by $1.00 per line	• Reduces the subsidy burden on heavy toll users • Minimizes market distortion – cost causer pays • Minimizes uneconomic arbitrage opportunities	• $1.00 per line increase • $125M

"Compromise" Solution Details

Solution Elements	Description	Benefits	PB Impact
• Per-Line Charge Back-up Options: *Modest Residual Per-Line Charge*	• Per-line charge billed to IXCs on a presubscribed line basis • IXCs may pass through per-line charges to their presubscribed end-users • Residual per-line charge applies to unbundled loops	• Reduces the subsidy burden on heavy toll users • Minimizes uneconomic arbitrage opportunities • Per-line NTS recovery is widely supported	• $0.70 per presubscribed line • $125M est. revenue increase
• Appropriately Sized Universal Service Fund	• $20 affordability benchmark • $7.3B interstate USF • Net Receipts from the interstate fund are available to offset NTS cost recovery (i.e. access prices reductions) • Does not include education or health care	• Competition and investment encouraged in high cost areas • Greater choice of providers for high cost customers • Preserves low basic rates everywhere	• $170 to $240M est. net receipts

- ***Impact of overall compromise solution would be revenue neutral on day one***

A Per-Line Charge is a Step in the Right Direction

- Subsidy recovered through a per-line charge is superior to subsidy recovered through a usage charge
  - The subsidy burden on heavy toll users is reduced
  - The per-line charge is spread more evenly across customers
  - The per-line charge is more closely aligned with how NTS costs are incurred

Universal Service Should be a Significant Part of Any Integrated Solution

- ***Subsidy to high cost areas must be specifically provided***
  - Implicit subsidies will be reduced
  - Technology is assisting high volume, low cost areas but not high cost areas
- ***Only the Universal Service solution addresses geographic variations in costs***
  - Geographic cost differences are enormous for loops. In one wirecenter in California (Chico), loop costs vary from $24 to $128.
  - With usage charges, high usage customers subsidize low usage customers
  - With a residual per-line charge, urban customers (particularly business customers) will continue to subsidize rural customers
- ***Universal Service is competitively neutral***
  - Funds are collected from all telecommunications providers
  - Subsidy payments are available to any carrier serving high cost areas

Subsidy Should Be Recovered From Unbundled Loops

- Universal service is at risk if a per-line charge is avoidable
  - As long as subsidy support remains in access charges (e.g., per-line charge), the same subsidy should apply to unbundled loops
  - Otherwise, real support for universal service will diminish as CLCs choose unbundled loops to serve customers in order to avoid the per-line charge

The Same Rates Should Apply to Functionally Equivalent Services

- The Act precludes carriers from charging different rates for functionally equivalent or "like" services
  - Unbundled loops and retail exchange lines provide the same functionality, whether purchased as unbundled elements or access lines
  - The same per-line charge should apply to unbundled loops and presubscribed lines

The Introduction and Expansion of Competition Makes Regulatory Relief an Imperative

- The introduction of local competition demands regulatory relief (i.e., pricing flexibility)
- The existence of intense competition in California is justification for further regulatory relief (i.e., removal of services/geographies from price caps)

Phase 1 Proposal - Pricing Flexibility

- Trigger: Interconnection Agreement or Statement of Generally Available Terms (SGAT)
- Elements of Phase 1 pricing flexibility:
  - Simplified price cap structure
  - Term and volume discounts
  - Contracts
  - Geographic deaveraging
  - New services treatment
- Benefit: Increases customers' options

Phase 2 - Removal of Services from Price Cap Regulation

- Trigger: Substantial competition has been demonstrated at the wire center level
  - Unbundled elements have been purchased
  - Minutes are exchanged
- Elements of Phase 2:
  - Remove competitive services and geographic areas from price cap regulation
- Benefit: Encourages innovation and investment

Removal of Competitive Services/Geographies From Price Caps

- Requires one time adjustment to PCIs and SBIs
- Will not increase headroom for services and/or geographies still subject to price caps
- Customers remaining in price caps will not be harmed

USTA Industry Summary of Access Competition
as of February 13, 1997[1]

	Industry	*Pacific Bell*	*% of Total Industry*
Access Lines	143M	15M	10%
Number of Competitive Networks	326	28	9%
Number of Colocation Cages or Virtual Equivalents	912	208	23%
Number of Cross-Connects			
DS1 Equivalents	111,193	20,701	19%
DS0 Equivalents	4,301	1,870	43%
Number of Local Interconnection Trunks	140,986	20,704	14%
Number of CLEC NXX Codes[2]	2,466	548	22%

(1) Other than the number of access lines & CLEC NXX codes, Ameritech data is not included.
(2) Number of NXX codes is provided by the Bellcore Traffic Routing Administrator.

Alternative Switching and Transport Abound

Metropolitan Area	*Competitive Fiber Networks*	*Fiber Miles* (Est.)	*Buildings On-Net* (Est.)	*Local Switching Capability* (doesn't include IXC POPs)	*NXX Codes Opened* (thru 3/1/97)	*Collocation Cages* (thru 3/1/97)	*Cross-Connects DS1 Equiv.* (thru 3/1/97)	*Local Interconnection Trunks* (thru 2/10/97)
San Diego	6	1,000	336	8	61	32	5,531	3,266
San Francisco	6	1,000	954	6	194	84	9,887	7,105
Los Angeles	8	3,000	486	11	184	32	7,200	6,244
Orange County	5	* Included In LA	* Included In LA	3	66	25	4,207	1,029
Sacramento	3	320	133	3	27	19	2,958	1,284
All Other	3	100	121	3	97	16	934	3,571
Total Serving Area	**31**	**5,420+**	**2,030+**	**35**	**629**	**208**	**30,717**	**22,500**

- Volume increase due to new Market Research and actuals
- Does not include wireless or IXC backbone networks

Competition in Pacific Bell's Service Areas is Robust and Growing

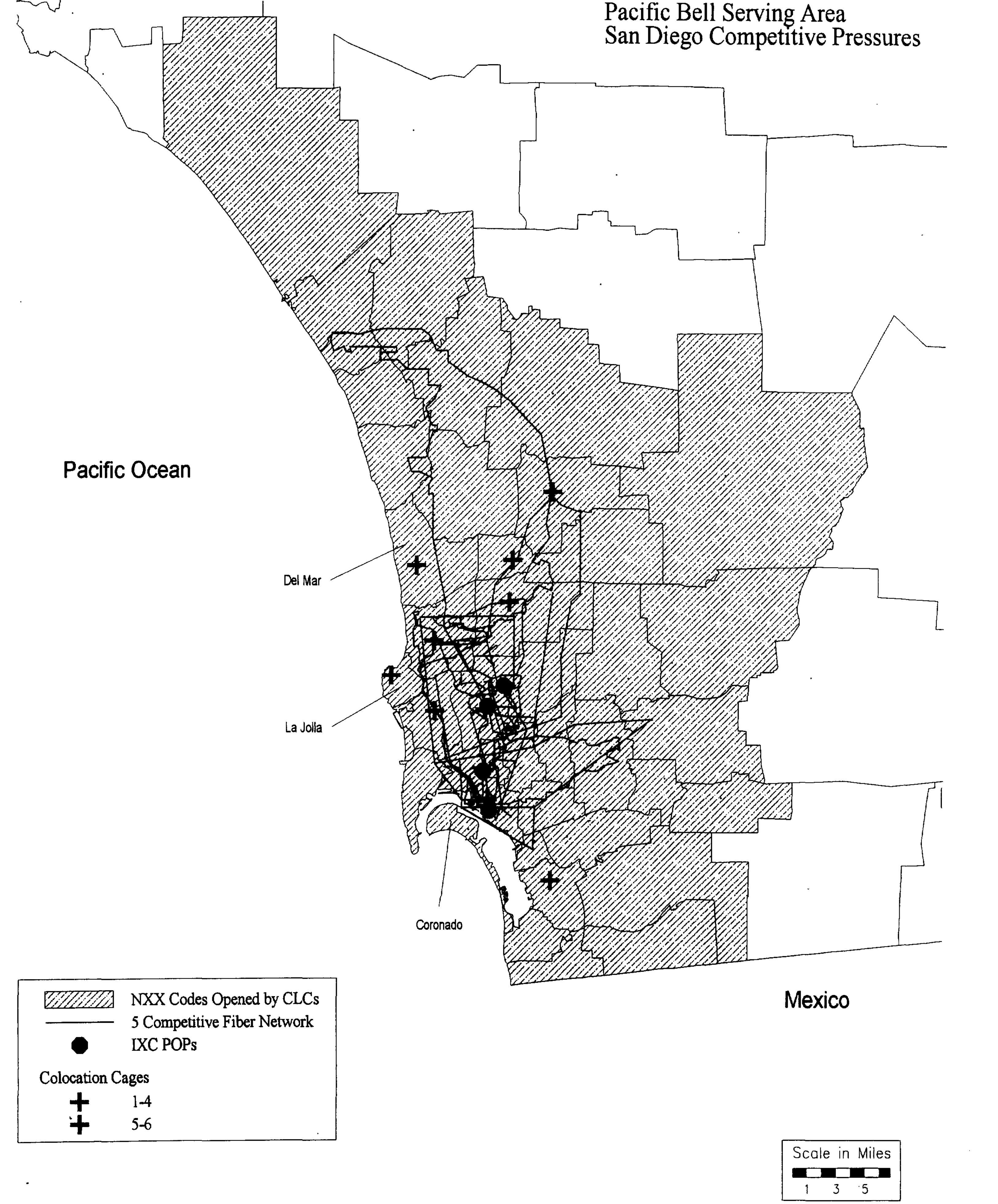
In just the past year....

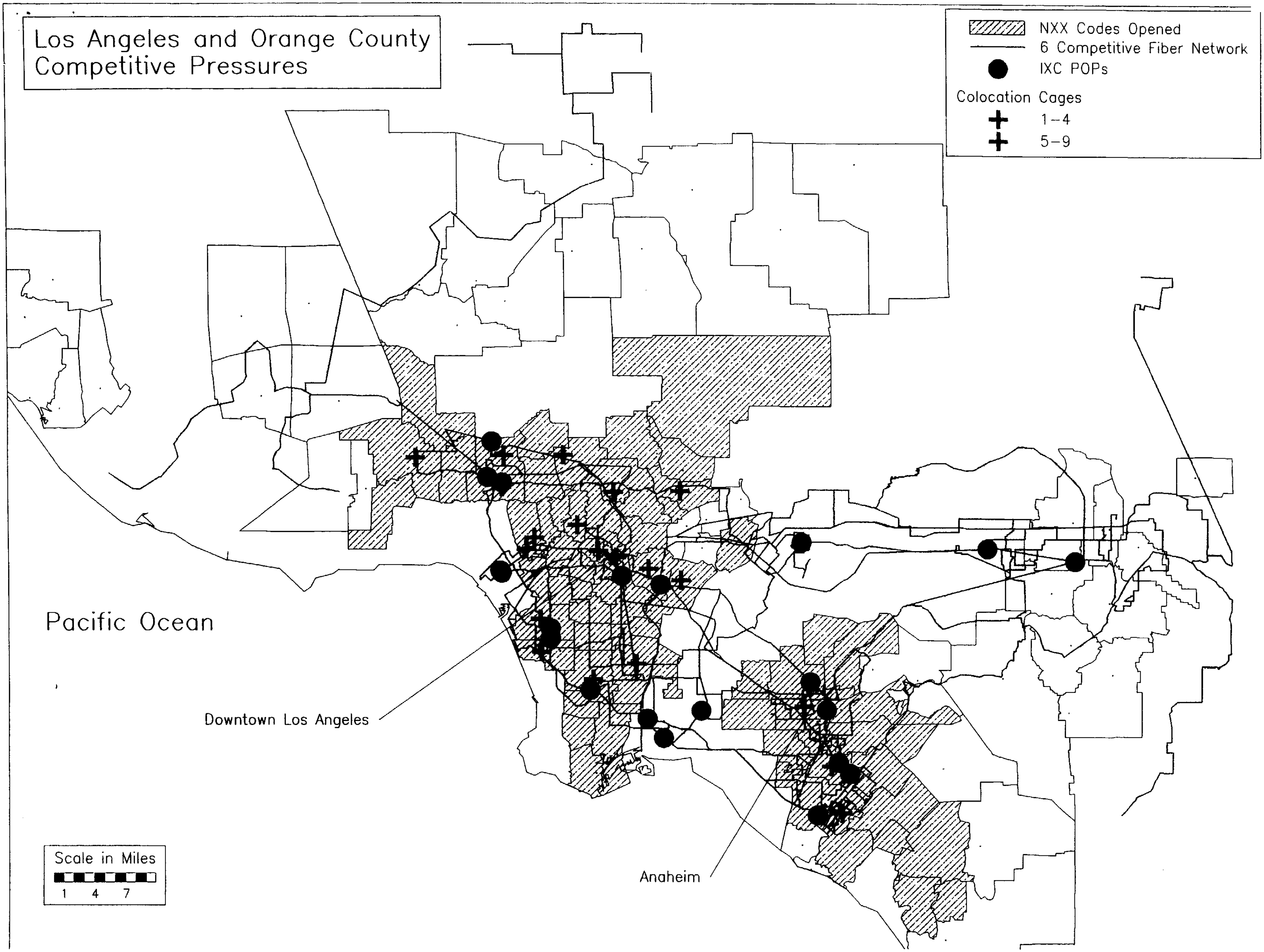
- PB lost 10% Hicap market share in both the SF & LA regions, down to 55%
- NXX code openings grew 260% from 176 to 629
- Colocation cages doubled from 106 to 208
- The number of cross-connects grew 270% from 8,300 DS1 Equivalents to 30,717 DS1 Equivalents
- 78 companies have been granted authority to offer local service in California and an additional 38 are pending approval
- 22,500 Local Interconnection trunks have been installed and PB is now exchanging over 115M MOUs monthly with 8 different CLCs
- PB processed 15,000 resale orders in the past two weeks

Competitive Access Provider Activity

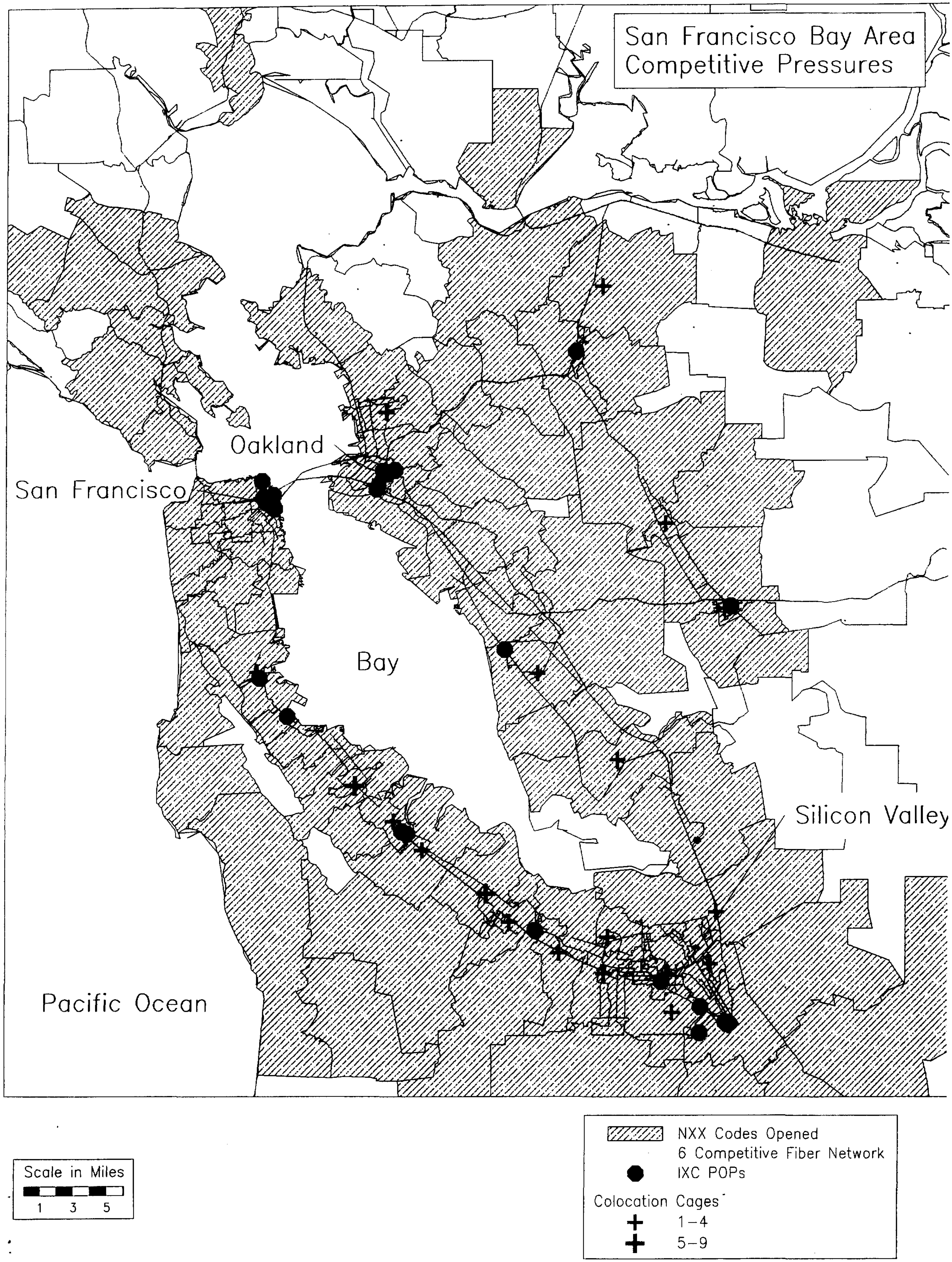
*Dots may represent more than 1 CAP Network
*Based on 3Q96 Market Research

Pacific Bell Serving Area
San Diego Competitive Pressures





Los Angeles and Orange County
Competitive Pressures
NXX Codes Opened
6 Competitive Fiber Network
IXC POPs
Colocation Cages
1–4
5–9
Pacific Ocean
Downtown Los Angeles
Anaheim
Scale in Miles
1 4 7


San Francisco Bay Area
Competitive Pressures
Oakland
San Francisco
Bay
Silicon Valley
Pacific Ocean
Scale in Miles
1 3 5
NXX Codes Opened
6 Competitive Fiber Network
IXC POPs
Colocation Cages
1–4
5–9

The Promise of the Telecommunications Act is *Deregulation*

- Degree of regulation should be commensurate with the level of competitive alternatives in a relevant market
- Contract-based tariffs and rate structure flexibility will foster more robust, competitive markets with maximum consumer benefits
- "Compromise" solution should include preservation of Universal Service supported by all providers and customers and lower, more cost-based access charges

Attachments

The Wall Street Journal
March 4, 1997

AT&T Plans $9 Billion Outlay This Year To Expand Its Network to New Markets

Stock Falls 7.5% on Forecast That Short-Term Profit Will Be Hurt by Costs

By JOHN J. KELLER
Staff Reporter of THE WALL STREET JOURNAL

BASKING RIDGE, N.J.—AT&T Corp.'s senior brass outlined plans to spend as much as $9 billion this year expanding the AT&T network into new markets, hurting short-term profit in an effort to position the company for major earnings gains in five years.

At the same time, officials said company managers have been told to cut $2.6 billion in costs over the next two years. The reductions will come from already-announced job cuts and other moves, including overhauling long-distance marketing and revamping AT&T's extensive real-estate holdings.

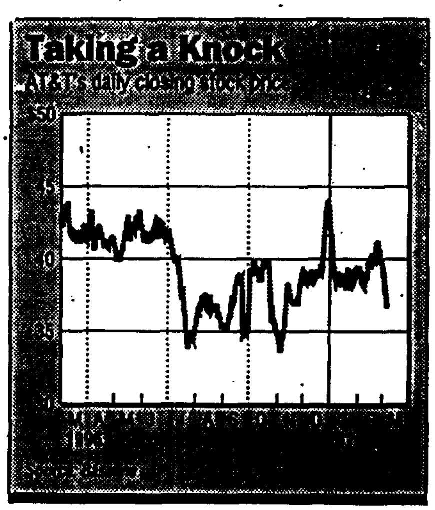
John R. Walter

The strategy, outlined in a briefing by Chairman Robert E. Allen and his designated heir, John R. Walter, who was meeting Wall Street analysts for the first time as an AT&T executive, wasn't received well by the markets. AT&T shares dropped 7.5% to $36.875, down $3, in composite trading yesterday on the New York Stock Exchange.

But analysts at the company's two-day briefing here seemed heartened by the candor of AT&T executives in explaining their strategy, notwithstanding the high costs of executing it.

The investments, which mark an increase of almost 50% above AT&T's normal capital spending, come as AT&T targets the Baby Bells' local-phone markets and rival Internet services. The spending "will put increasing strain on our financial performance," but should "put AT&T on a path for powerful growth," Mr. Allen told analysts.

Mr. Allen, after opening the session, quickly handed off to his newly hired No. 2, Mr. Walter, who is AT&T's president. Mr. Walter pledged to attain $5 to $6 per-share earnings by year-end 2001, compared with $3.47 a share in 1996, which included losses from discontinued operations.



No Additional Layoffs Seen

Mr. Walter told analysts the cost reductions would ease the earnings blow and would be achieved without any additional job cuts beyond the 17,000 layoffs announced in January 1996.

The accelerated capital spending will contribute to a significant decline in first-quarter earnings, to the 70-cents-a-share range, Mr. Walter indicated, down from the 90-cents-a-share earned in the first quarter last year. While not making that direct comparison, he said first-quarter net would be "slightly below — less than 10%" — the 76 cents that AT&T earned in the fourth quarter of 1996.

Moreover, earnings from AT&T's core long-distance and wireless businesses, which translated into $4.06 per share in 1996, will likely fall 8% to 15% in 1997, coming in at a range of $3.45 to $3.75 per share, Mr. Walter said.

Attacking on All Fronts

The decline, moreover, could be even steeper, AT&T said — perhaps knocking down earnings for the core business to as low as $2.45 per share, depending on how much the company has to spend on marketing new initiatives, Mr. Walter said. The new push could mean 75 cents to $1 per share in further reductions beyond the $3.45-to-$3.75 range, he explained.

Mr. Walter made it clear that AT&T is going on the attack in all markets from local-phone services dominated by the Baby Bells and GTE Corp. to Internet services; he said he would personally oversee the latter. He also made it clear that AT&T managers would pay a heavy price for failing to meet the company's targets.

"Achieving best-in-class is not negotiable — it's absolutely imperative," Mr. Walter said. "We're going to tie our compensation to it. Our jobs depend on it."

The blunt forecast and two-fisted posture were part of an effort to rebuild AT&T's credibility on Wall Street. The company has lost almost two points of market share in the past year to competitors ranging from MCI Communications Corp. and Sprint Corp. to simple "dial-around" carriers that AT&T customers can use to bypass the incumbent carrier by pressing a few buttons.

But the prospect of further spending and looming competition from the Bells and others is likely to further hurt AT&T's short-term prospects. Many analysts may continue to regard the company's stock with little enthusiasm until Mr. Walter and AT&T begin to turn things around.

Jack B. Grubman, analyst at Salomon Brothers Inc., called Mr. Walter's forecast of AT&T's spending and near-term earnings "the most candid assessment of AT&T's financial performance since its 1984 breakup." But Mr. Grubman said he remains pessimistic, adding that the company will be increasing its investments at the same time as competition continues to increase. "The issue is simple," Mr. Grubman said. "What we know with some degree of certainty is that the next two or three years are going to be tougher. Can they get to their financial goals in year five?"

In January, Mr. Grubman cut his 1997 earnings estimate to $3 a share. Yesterday, he reduced the estimate again, to $2.55 per share. "The earnings dilution in the core business is bigger than any of us thought," he said.

AT&T's audacious spending will in its first stages include the total resale of the Bells' services, including the use of the Bells' network facilities, in much of the country as it seeks to convert the Bells' local phone customers to its own local service. "It's very important for us to get in quickly," said Gail McGovern, executive vice president of AT&T's Consumer Markets. "Our customers want a single bill and we'll do what we have to to deliver that."

Long-term AT&T will resell portions of the Bell network, at a greatly reduced cost, build its base of local customers and then use this foundation to fund its own construction of additional network switching and transmission facilities, AT&T executives said.

In the corporate market, AT&T has begun offering Digital Link, a service that connects AT&T business customers directly to the AT&T network and lets them make outbound local calls, bypassing the Bells. Currently Digital Link is accessible to 60% of the nation, according to Jeff Weitzen, AT&T's Business Markets executive vice president. By the end of the year, business customers will be able to get inbound calls as well, delivered by the AT&T network, not only boosting AT&T's revenue but cutting its sizable access payments to the Bells for connecting calls locally, executives said.

AT&T can hit a big part of the country with relatively little in the way of its own network facilities. The Bells' 22,000 switches dwarf AT&T's roughly 140. But only about 1,200 of those Bell switches handle 75% of local traffic, estimated John Petrillo, AT&T's strategy chief.

Meanwhile, AT&T has been bulking up its own system. Frank Ianna, president of the AT&T network, said the company doubled its call-handling capacity between 1994 and 1995. And last year, when the company spent $6.7 billion on its network, it doubled the capacity of its powerful signaling network, which tells traffic where to go.

On the cost-cutting side, AT&T said it will scale back significantly the practice of sending checks to long-distance customers and will replace that with a less-expensive loyalty program in which customers are rewarded with free long-distance service for staying with AT&T.

By its presentation AT&T reinforced that it has "a lot of power in the organization . . . and good management depth," said Thomas Aust, an analyst at Citicorp Securities Inc. But he said, "There is still major uncertainty as to whether they can capture local customers and whether they're too dependent on what may turn out to be a very fragile marketing theme."

AT&T will have to go for a massive pre-emptive strike in the local market if it is to appropriately stun the Bells and other local rivals seeking its long-distance clients. Mr. Petrillo said GTE and Southern New England Telecommunications Inc. have already made sizable inroads into AT&T's long-distance turf by bundling their own local and long-distance offerings for customers.

"The costs of reacquiring those customers is high, higher than it cost to originally acquire them," Mr. Petrillo said.